Supreme Court, U.S.
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No. 04-

IN THE

Supreme Court of the United States

IRVING PULP & PAPER, LIMITED d/b/a IRVING PAPER,

Petitioner,

v.

CAPITAL FACTORS, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Section 364 of the Bankruptcy Code, 11 U.S.C. § 364, authorizes a chapter 11 debtor to borrow money and obtain goods and services on credit. In many chapter 11 cases, debtors seek to borrow money or obtain goods and services on credit from preexisting lenders and suppliers. In order to encourage a preexisting lender or supplier to extend credit, the debtor typically requests the bankruptcy court to approve credit terms favorable to the lender or supplier, including the treatment of the creditor's unpaid pre-petition claim as a priority obligation in the debtor's bankruptcy case.

Section 364(e) of the Code, 11 U.S.C. § 364(e), prevents an appellate court from overturning an authorized credit transaction to a lender or supplier that extends credit in good faith unless the party objecting to the transaction first obtained a stay of the transaction pending appeal. The question presented is:

Should the Court grant certiorari to resolve a three-way circuit conflict over whether and to what extent section 364(e) of the Bankruptcy Code protects an order approving a credit transaction from subsequent appellate modification?

RULE 29.6 STATEMENT AND PARTIES TO THE PROCEEDING

Petitioner is Irving Pulp & Paper, Limited d/b/a Irving Paper. The parent companies of petitioner are The New Brunswick Railway Company, FMP Company, Limited, and K.C. Irving, Limited. No public company owns 10 percent or more of the stock of Irving Paper. Respondent is Capital Factors, Inc. Kmart Corporation, Handleman Company, and Knight-Ridder, Inc., were parties to the proceedings below.

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JURISDICTION

The court of appeals entered its judgment on February 24, 2004. A petition for rehearing and rehearing *en banc* was timely filed on March 9, 2004. The court of appeals denied the petition on May 6, 2004. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

RELEVANT STATUTORY PROVISIONS

Section 364(a) of the Bankruptcy Code, 11 U.S.C. § 364(a), provides in relevant part:

> [U]nless the [bankruptcy] court orders otherwise, [a chapter 11 debtor] may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

Section 364(b) of the Bankruptcy Code, 11 U.S.C. § 364(b), provides:

> The [bankruptcy] court, after notice and a hearing, may authorize [a chapter 11 debtor] to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.

Section 364(e) of the Bankruptcy Code, 11 U.S.C. § 364(e), provides:

> The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any

> debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority, were stayed pending appeal.

STATEMENT

This case arises out of the chapter 11 bankruptcy proceedings of Kmart Corporation ("Kmart"). When a debtor such as Kmart files for bankruptcy, it often requires immediate access to credit in order to continue its operations. Recognizing this business reality, section 364 of the Bankruptcy Code broadly authorizes a chapter 11 debtor to "obtain credit or incur debt," and this authorization includes obtaining credit from trade vendors who supply the debtor with necessary goods and services. *See Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 12 (2000).

Specifically, section 364(a) authorizes the debtor to obtain credit or incur debt "in the ordinary course of business." 11 U.S.C. § 364(a).[1] Pursuant to this provision, a debtor may obtain goods and services on credit without prior court approval if the goods and services are those that the debtor typically would purchase to conduct its usual and customary operations. Goods and services falling within the scope of section 364(a) would include items or supplies that a debtor such as Kmart normally sells in its stores or consumes in the

1. Section 364(a) expressly authorizes a "trustee" to obtain credit or incur debt. In a chapter 11 case, however, a trustee typically is not appointed. Instead, the debtor remains in control of its assets and operations as the "debtor in possession" and enjoys the powers of a trustee. *See* 11 U.S.C. § 1101(1) (defining "debtor in possession" to mean the debtor in a chapter 11 case); § 1104 (providing for the appointment of a trustee under limited circumstances); § 1107(a) (providing that the debtor as "debtor in possession" is granted the rights and powers of a trustee). Accordingly, the term "trustee" as used in section 364 includes a chapter 11 debtor in possession such as Kmart. *See Hartford Underwriters*, 530 U.S. at 6 n.3 (observing that a debtor in possession in a chapter 11 case is "expressly given the rights and powers of a trustee by 11 U.S.C. § 1107."); 3 *Collier on Bankruptcy*, ¶ 364.02 at 364-4 (15th ed. rev. 2002) (observing that, pursuant to section 1107, a debtor in possession may obtain credit under section 364).

ordinary course of its retailing operations. *See Credit Alliance Corp. v. Idaho Asphalt Supply, Inc. (In re Blumer)*, 95 B.R. 143, 147-48 (B.A.P. 9th Cir. 1988) (after filing for bankruptcy, debtor engaged in road building business could obtain asphalt on credit in the ordinary course of business under section 364(a) without prior court approval).

Similarly, section 364(b) authorizes the debtor to obtain credit or incur debt other than in the ordinary course of business, provided that the bankruptcy court first approves the transaction after notice and a hearing. Under this provision, a debtor, with court approval, may purchase on credit goods and services that it does not customarily use in its operations, or purchase goods and services on credit terms that are not usual and customary. *See In re Payless Cashways, Inc.*, 268 B.R. 543, 546-47 (Bankr. W.D. Mo. 2001) (after filing for bankruptcy, debtor engaged in sale of lumber could obtain necessary supplies on credit other than in the ordinary course of business where the credit terms included the debtor's payment of the suppliers' preexisting invoices).

Sections 364(a) and (b) each authorize the treatment of the cost of credit as an expense of administration entitled to priority payment under section 503(b)(1) of the Code. 11 U.S.C. §§ 364(a), (b). *See also* 11 U.S.C. § 507(a)(1) (providing for the priority payment of administrative expenses). In addition, sections 364(c) and (d) authorize the debtor to grant superpriority status, or to pledge collateral, to secure an extension of credit if certain conditions are satisfied. 11 U.S.C. §§ 364(c), (d). *See Hartford Underwriters*, 530 U.S. at 12 (explaining that trade creditors who provide goods or services to the debtor on credit may "obtain superpriority under § 364(c)(1) or a security interest under §§ 364(c)(2), (3), or § 364(d)" to secure their post-petition extensions of credit).[2]

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2. The term "superpriority" refers to administrative priority ahead of ordinary administrative priority. Secured creditors are generally paid from their collateral ahead of all administrative claimants, including those granted superpriority. *See Hartford Underwriters*, 530 U.S. at 5 (observing that "[a]dministrative expenses . . . do not have priority over secured claims"); 3 *Collier*, ¶ 364.04[2][b] at 364-12-13 (discussing superpriority and secured credit transactions under section 364).

In turn, section 364(e) expressly protects the creditor who has extended credit under either section 364(a) or (b) from having its credit transaction overturned on appeal. Specifically, section 364(e) provides that "[t]he reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted," provided that the creditor extended the credit in good faith and the party objecting to the credit transaction did not obtain a stay of the transaction pending appeal. 11 U.S.C. § 364(e). Section 364(e) is vitally important for creditors and debtors in bankruptcy because it assures that the parties may, in reliance upon its protections, act immediately to consummate their credit agreement free from appellate uncertainty, thus facilitating necessary credit transactions. *See Burchinal v. Central Washington Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 1489 (9th Cir. 1987) ("[T]he purpose of section 364(e) was to overcome a good faith lender's reluctance to extend financing in a bankruptcy context by permitting reliance on a bankruptcy judge's authorization.").

After filing its bankruptcy case, Kmart required shipments of paper from petitioner Irving Pulp & Paper, Limited ("Irving") to print its advertising circulars. The circulars are critically important to Kmart's business because Kmart estimates that the circulars generate over 30% of its sales volume. (Pet. App. 51a; 70a). At the time Kmart filed for bankruptcy, however, many of its suppliers (including Irving) were reluctant to ship goods to Kmart on credit given Kmart's bankruptcy status and its failure to pay the pre-petition invoices of many of its vendors (including Irving's pre-petition invoice of approximately $3.5 million).[3] To overcome this reluctance and normalize its business relationships with its critical trade suppliers, Kmart filed a motion with the bankruptcy court seeking approval of a form of credit transaction that would allow

3. The term "pre-petition" refers to claims, events, or transactions that arise before a debtor files a petition commencing a bankruptcy case. In turn, the term "post-petition" refers to claims, events, or transactions that arise after the debtor files a petition commencing its bankruptcy case.

Kmart to obtain ongoing shipments of goods on credit in a manner satisfactory to both Kmart and its vendors. (Pet. App. 45a). On January 25, 2002, after notice and a hearing, the bankruptcy court approved Kmart's proposed form of credit transaction and entered an order accordingly (the "Vendor Order" or "Order," Pet. App. 29a).

The Vendor Order expressly authorized Kmart to pay the relevant supplier's outstanding pre-petition invoice as an administrative expense, provided that the supplier agreed to ship goods to Kmart on ordinary credit terms for a two-year period. (Pet. App. 29a-32a). Under the terms of the Vendor Order, the supplier also had to agree to waive any lien or reclamation rights that it had with regard to any goods shipped. (Pet. App. 32a).[4] The Vendor Order thus provided Kmart with the certainty that critical suppliers who agreed to the terms of the Order would ship necessary items on ordinary credit terms for an extended period. The Order likewise provided the critical vendors with the certainty that their pre- and post-petition claims for shipped goods would be paid on a priority basis.

After the bankruptcy court entered the Vendor Order, Irving agreed to the provisions of the Order and commenced shipping tens of millions of dollars worth of goods to Kmart on favorable credit terms. In turn, Kmart paid Irving's pre-petition invoice in the amount of approximately $3.5 million as an expense of administration and thereafter Kmart paid Irving for its post-petition shipments. In addition, Irving relinquished any lien or reclamation rights that it had with regard to the goods that it had shipped.

Kmart's agreement to treat Irving's pre-petition invoice as a priority expense of administration provided a significant inducement to Irving to extend post-petition credit to Kmart. Without the priority treatment, Irving's pre-petition claim would have merely constituted a general unsecured claim against Kmart's bankruptcy estate (putting aside Irving's lien and reclamation rights, if any, applicable

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4. For a discussion of reclamation rights asserted in the Kmart case, *see* Pet. App. 70a-72a.

to a portion of its claim). In the vast majority of chapter 11 cases, general unsecured creditors recover only a fraction of the face amount of their claims, and Kmart's bankruptcy is typical in this regard. With priority treatment, however, Irving stood a far better chance of being paid in full.[5]

The Vendor Order authorized a common type of bankruptcy credit transaction. In many chapter 11 cases, the debtor cannot reorganize without shipments of necessary goods and services on credit, and would prefer to obtain essential supplies on the most favorable credit terms available. It is common practice that, in exchange for a vendor's agreement to ship goods on ordinary credit terms (e.g., credit terms that the vendor would provide to financially healthy firms), the debtor agrees, with bankruptcy-court approval, to pay the vendor's outstanding pre-petition invoice. Indeed, as counsel for respondent observed in the bankruptcy court in this case, this kind of transaction is "done all over." (Pet. App. 85a).

On February 1, 2002, without notifying Irving and without seeking or obtaining a stay of the Vendor Order, respondent Capital Factors, Inc. ("Capital") appealed the Vendor Order to the district court. Over a year later, on April 8, 2003, the district court reversed the Vendor Order – again without notice to Irving. In reversing the Vendor Order, the district court concluded that the form of credit transaction approved in the Order – in particular, the payment of the

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5. Conferring administrative expense status on a supplier's pre-petition claim, while beneficial, does not assure payment in full. In some chapter 11 cases, the debtor is unable to pay all of its administrative expenses in full because it lacks the funds to do so. In such cases, the debtor is "administratively insolvent." An example is the chapter 11 bankruptcy case of the Caldor chain of retail stores. *See Term Loan Holder Comm. v. Ozer Group, LLC (In re Caldor Corp.)*, 303 F.3d 161, 164 (2d Cir. 2002) (noting administrative insolvency of debtor). Accordingly, conferring administrative expense status simply reduces the risk of non-payment. *See General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 75 (2d Cir. 1984) ("Under the law as it presently exists, knowledgeable bankruptcy attorneys must be aware that the priority ordinarily given to administration expenses may prove illusive" if the claims of more senior creditors exhaust the debtor's assets.) (quotations omitted).

critical suppliers' pre-petition invoices in exchange for their agreement to extend credit post-petition – was erroneous. (Pet. App. 23a). Thereafter, Irving intervened in the district court and appealed the district court's order to the Seventh Circuit Court of Appeals.

Irving argued in the Seventh Circuit that sections 364(a) and (b) authorized the credit transaction set forth in the Vendor Order, including the payment of Irving's pre-petition invoices as part of the cost of credit. (*See Brief of Appellant Irving Pulp & Paper, Limited d/b/a Irving Paper*, filed in case nos. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347, & 03-2348 (consolidated) at 8-14). Irving also argued that, pursuant to section 364(e), it was entitled to the benefit of the Vendor Order because Irving had extended credit to Kmart in good faith and Capital did not seek or obtain a stay of the order pending appeal. (*Id.* at 26-28). Rejecting both arguments (as well as the arguments advanced by other appellants), the Seventh Circuit affirmed the district court's order.

In reaching its conclusion, the Seventh Circuit acknowledged that section 364(e) does "forbid revision of transactions completed under judicial auspices." (Pet. App. 4a). Nevertheless, the court concluded that nothing in the Bankruptcy Code "covers payments made to pre-existing, unsecured creditors" such as Irving whose pre-petition invoices were paid in accordance with the Vendor Order as part of their agreement to provide post-petition credit to Kmart. (Pet. App. 4a). The court also recognized that section 364(b) "authorizes the debtor to obtain credit (as Kmart did)," but concluded that this authority does not extend to the payment of a supplier's pre-petition invoices as part of a post-petition credit transaction. (Pet. App. 9a).

In affirming the district court, the Seventh Circuit recognized that the critical suppliers such as Irving had fulfilled their end of the bargain by extending credit to Kmart under the terms of the Vendor Order. (Pet. App. 5a) ("[A]fter the order, they continued selling goods and services to Kmart (doing this was a condition of payment for pre-petition debts)."). The court also acknowledged that, with the Vendor

Order reversed, Kmart could and would proceed to recover all the payments that Kmart had made to suppliers on account of their pre-petition invoices, even though these payments had been a part of the credit terms. The court concluded: "If the [Vendor Order is] invalid, then the critical vendors have received preferences that Kmart is entitled to recoup for the benefit of all creditors." (Pet. App. 3a-4a).

Indeed, following the district court's reversal of the Vendor Order, Kmart began suing its critical suppliers to recover the payments that Kmart had made to them on account of their pre-petition invoices. Since the Seventh Circuit's ruling, Kmart has pursued literally thousands of lawsuits to recover hundreds of millions of dollars from suppliers whose pre-petition invoices Kmart paid under the terms of the Vendor Order. Most of these lawsuits remain pending and will take years to resolve. Among the pending suits, Kmart has specifically sought to recover the approximately $3.5 million that it paid to Irving on account of Irving's pre-petition invoices. *See Kmart Corp. v. Irving Paper, Inc.*, Adv. Case No. 04A00129 (Bankr. N.D. Ill.) (Pet. App. 73a). Kmart contends that, now that the Vendor Order has been overturned, Kmart's payment of Irving's pre-petition invoices was not "authorized" and, therefore, may be set aside and recovered as an unauthorized post-petition transfer under sections 549 and 550 of the Bankruptcy Code. (Pet. App. 76a). It is clear that, but for the district court's reversal of the Vendor Order, Kmart would not be able to recover these payments because section 549 only permits the avoidance of *unauthorized* post-petition transactions, not those the bankruptcy court approved. *See* 11 U.S.C. § 549(a)(2)(B) (providing that "the trustee may avoid a transfer of property of the estate . . . that is not authorized under this title or by the court."); 5 *Collier on Bankruptcy*, ¶ 549.04[3] at 549-10 (15th ed. rev. 2003) ("Section 549 provides that transfers made under the authority of the Code are not voidable"); *id.*, ¶ 549.04[4] at 549-11 ("Transfers authorized by the bankruptcy court . . . would also not be within the avoiding powers. . . .").

REASONS FOR GRANTING THE PETITION

The circuits are intractably divided in a three-way split over whether and to what extent section 364(e) of the Bankruptcy Code protects a court-approved credit transaction from subsequent appellate reversal or modification. Given the importance of credit transactions in chapter 11 proceedings (which are necessary in virtually all of the thousands of chapter 11 cases that are filed each year and which can easily amount to billions of dollars in a single case, as the Kmart bankruptcy itself illustrates), the conflict among the courts, and the uncertainty that it creates, is untenable. This case presents an ideal vehicle to resolve this split of authority because the issue is presented simply and clearly in the context of a common and recurring type of bankruptcy credit transaction. Further, resolution here of the question presented is outcome-determinative. Certiorari is also warranted because the Seventh Circuit's decision is wrong on the merits.

I. The Courts of Appeals Are Intractably Divided Into Three Camps Over the Question Presented and Review in this Court is Necessary and Warranted To Resolve the Conflict.

Under section 364(e), a creditor is entitled to the benefit of a bankruptcy court's order approving the terms of a credit transaction, so long as the creditor extends credit in good faith and no party has obtained a stay of the order approving the transaction. 11 U.S.C. § 364(e). The Sixth and Ninth Circuits have concluded that section 364(e) protects from appellate reversal a court-approved credit transaction that includes the priority treatment of a creditor's pre-petition claim as part of the terms of the transaction. *See In re Adams Apple*, 829 F.2d at 1488 ("We therefore conclude that section 364(e) is meant to protect the lender by preventing reversal of a [court-approved credit term requiring the priority treatment of the lender's pre-petition claim in exchange for the lender's post-petition extension of credit] unless a stay is obtained pending appeal."); *Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. of Escanoba (In re Ellingsen MacLean Oil Co.)*, 834 F.2d 599, 604 (6th Cir. 1987) ("[W]e conclude that the amended order

[establishing the priority treatment of the post-petition lender's pre-petition claim by prohibiting any challenge to the validity of the pre-petition liens securing the claim] should also be deemed to be protected by the provisions of section 364(e)."); *see also Boullioun Aircraft Holding Co., Inc. v. Smith Mgmt. (In re Western Pacific Airlines, Inc.)*, 181 F.3d 1191, 1196 (10th Cir. 1999) (following the Ninth Circuit's approach in *Adams Apple* and concluding that "[W]e read § 364(e) to apply not just to the validity of financing itself, but also to the terms"); *New York Life Ins. Co. v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 901 F.2d 1359, 1364 (6th Cir. 1990) (same).[6]

In contrast, the Eleventh Circuit, now joined by the Seventh Circuit, has concluded that section 364(e) does not provide such protection. *See In re Kmart Corp.*, 359 F.3d 866, 869 (7th Cir. 2004) (concluding that section 364(e) does not "cover[] payments made to pre-existing, unsecured creditors" as part of a court-approved credit transaction); *Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490, 1493 (11th Cir. 1992) (stating that "[w]e reject the reasoning of *In re Adams Apple* and *In re Ellingsen*" and holding that a credit term requiring the priority treatment of a lender's pre-petition claim in exchange for the lender's post-petition extension of credit is not protected by section 364(e)).[7] In addition, the Second Circuit has concluded that, although the bankruptcy court has the jurisdictional "authority" to approve a credit transaction that includes the priority treatment of the creditor's pre-petition claim, an appellate court may reverse the bankruptcy court's authorization if certain procedural requirements are

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6. In its brief filed in the Seventh Circuit, Irving relied on, among other cases, the Ninth Circuit's decision in *Adams Apple* and the Tenth Circuit's decision in *Western Pacific* in making its argument under section 364(e). (*See Brief of Appellant Irving Pulp & Paper, Limited d/b/a Irving Paper*, filed in case nos. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347, & 03-2348 (consolidated) at 26-28; *see also Brief for Amicus Curiae Submitted by Meridian Retail, Inc.*, at 13-15 (citing *Adams Apple* and *Ellingsen*)).

7. In opposing Irving's argument under section 364(e), Capital relied on the Eleventh Circuit's decision in *Saybrook*. (*See Brief of Appellee Capital Factors, Inc.*, filed in case nos. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347, & 03-2348 (consolidated) at 93-94).

not satisfied. *See Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)*, 596 F.2d 1092, 1198, 1100 (2d Cir. 1979) (in reversing financing order, court noted that, for jurisdictional purposes, "[t]he financing order was within the parameters of the bankruptcy court's authority," but concluded that it "should not have been granted by an ex parte order" entered "solely on representations by a debtor in possession").

In turn, the Third Circuit has adopted yet another approach in applying section 364(e). *See The Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.)*, 16 F.3d 552, 562 (3d Cir. 1994) ("As we already have set forth, in our view section 364(e) does not preclude a court from reversing an authorization absent a stay" and applying an approach distinct from that of the other circuits).

Review by this Court is necessary and warranted to resolve the conflict among the courts of appeals over the proper application of section 364(e) because the circuit courts have embraced diametrically opposed views; the conflict is irreconcilable and has existed for a prolonged period; the disagreement is unlikely to diminish with the passage of time; the conflict extends across a number of appellate decisions; all of the relevant issues have been fully vetted in the lower courts; and the conflict is unlikely to be resolved in the courts below through resort to *en banc* procedure. Indeed, the Seventh Circuit refused to review *en banc* the question presented in this case, as did the Sixth Circuit in *Ellingsen*.

Moreover, this case presents an ideal vehicle to resolve the conflict among the circuits because resolution of the question presented is outcome-determinative. Likewise, this case presents a clear basis for resolution of the conflict in the context of the type of bankruptcy credit transaction responsible for the division among the courts of appeals over the proper application of section 364(e) — namely, the priority treatment of a creditor's pre-petition claim as part of the parties' post-petition credit terms. In addition, because the form of credit transaction in this case is exceedingly common, the issue of an appellate court's ability to review the transaction under section 364(e) will recur again and again. Accordingly, certiorari is warranted.

A. Review Is Warranted Because the Courts of Appeals Are Divided over the Question Presented.

As noted, the Ninth and Sixth Circuits have concluded that section 364(e) protects from appellate reversal or modification a court-approved credit transaction that includes the priority treatment of the creditor's pre-petition claim as part of the credit terms. *See In re Adams Apple*, 829 F.2d at 1488; *In re Ellingsen MacLean Oil*, 834 F.2d at 604; *see also In re Western Pacific Airlines*, 181 F.3d at 1196 (following *Adams Apple*); *In re Revco D.S.*, 901 F.2d at 1364 (following *Adams Apple* and *Ellingsen*); *Bank of New England v. BWL, Inc.*, 121 B.R. 413, 416-18 (D. Me. 1990) (following *Adams Apple*).

In *Adams Apple*, the debtor moved the bankruptcy court for approval of a post-petition credit transaction involving the creditor's agreement to extend post-petition credit to the debtor in exchange for the debtor's treatment of the creditor's pre-petition claim on a priority basis as part of the credit terms. Prior to its bankruptcy filing, the debtor owed the creditor an unsecured debt of $450,000. After the debtor filed for bankruptcy, the creditor agreed to extend additional credit, provided that the debtor agreed to treat the $450,000 pre-petition debt as entitled to priority status on a secured basis under section 364. As noted in the court's opinion, the practice of elevating a pre-petition debt to post-petition priority status in exchange for new credit is known colloquially as "cross-collateralization." *Adams Apple*, 829 F.2d at 1486 n.1.

After the bankruptcy court approved the credit transaction, a group of creditors appealed – first to the district court (which rejected the appeal), and then to the Ninth Circuit. Relying on section 364(e), the Ninth Circuit observed that "[a]n appellate court may not reverse the authorization to obtain credit or incur debts under section 364 if the authorization was not stayed pending appeal unless the lender did not act in good faith." 829 F.2d at 1487-88. Recognizing that "[s]ection 364 authorizes a bankruptcy court to permit the use of a variety of financing devices," the court considered whether the practice of elevating a creditor's pre-petition claim to priority status in exchange for post-petition credit was such a device. Although the court observed that the text of section

364 "does not indicate whether Congress intended to include a device that permits a creditor to promote his pre-petition debt" to priority status, the court stated that the practice "appear[s] to be covered by section 364, and in turn subject to section 364(e)." *Id.* at 1488. Moreover, the Ninth Circuit determined that, even if the bankruptcy court's order approving the transaction was erroneous because the transaction did not involve a legitimate financing term, the creditor was still entitled to the protection of section 364(e) so long as the creditor extended credit in good faith and the objecting party failed to obtain a stay of the bankruptcy court's order. 829 F.2d at 1488 n.6 ("Because the bankruptcy judge thought that cross-collateralization was legal and entered an order to that effect upon which the creditor relied, we conclude that the creditor should receive the protection of section 364(e) in this case."). The court held: "[w]e therefore conclude that section 364(e) . . . protect[s] the lender by preventing reversal of a cross-collateralization clause unless a stay is obtained pending appeal." *Id.* at 1488.

In applying section 364(e), the Ninth Circuit reasoned that "[s]ection 364 was designed to provide a debtor a means to obtain credit after filing bankruptcy." *In re Adams Apple*, 829 F.2d at 1488. The court further observed that "[a] lender may be willing to extend credit if the arrangement includes a cross-collateralization clause, . . . but would withhold credit if the clause could be overturned on appeal." *Id.* Rejecting the argument that section 364(e) did not apply because the lender "has not 'relied' on a bankruptcy court's authorization if the lender has recouped fully its post-petition outlay," the court stated that, without the added compensation afforded by the priority treatment of the creditor's pre-petition claim, "lenders may choose to invest in other enterprises." *Id.* As a result, the "[c]ongressional intent of fostering private investment in failing companies by promoting reliance on a bankruptcy court's authorization would be defeated." *Id.*

In *Ellingsen*, the debtor similarly moved the bankruptcy court for approval of a post-petition credit transaction involving the creditor's agreement to extend post-petition credit in exchange for the debtor's agreement to forego any

challenge to the creditor's pre-petition liens securing the creditor's pre-petition claim. After the bankruptcy court approved the credit transaction, a group of creditors appealed — first to the district court (which dismissed the appeal under section 364(e)), and then to the Sixth Circuit.

Recognizing that the debtor's agreement to forego any challenge to the creditor's pre-petition liens was "part of the whole 'package' [of credit terms that the bankruptcy court] authorized under section 364," the court considered whether the statute permitted this type of financing arrangement for purposes of section 364(e). *Ellingsen*, 834 F.2d at 602. Determining that it might, the court concluded that the bankruptcy court's authorization of the transaction "does not exceed section 364(e)'s protection." *Id.* at 604. The court added: "'The proper recourse for the objecting creditor is to get the transaction stayed pending appeal.'" *Id.* at 604-05 (quoting *In re EDC Holding Co.*, 676 F.2d 945, 947 (7th Cir. 1982)). Like the Ninth Circuit, the Sixth Circuit determined that, even if the bankruptcy court's order was arguably in error, the creditor was still entitled to the protection of section 364(e) so long as the creditor acted in good faith and the objecting party failed to obtain a stay. *Ellingsen*, 834 F.2d at 603 ("[T]he mere allowance of cross-collateralization in some degree as a financing tool should not categorically deprive an order of section 364(e) protection. More important than the nature of the advantage given the [b]anks for extending further credit is the fact that unsecured creditors failed to obtain a stay.").

In contrast, the Eleventh Circuit — now joined by the Seventh Circuit in the decision below, *see In re Kmart*, 359 F.3d at 869 — has concluded that section 364(e) does not protect a court-approved credit transaction that includes the priority treatment of the creditor's pre-petition claim as part of the credit terms. *See In re Saybrook Mfg. Co.*, 963 F.2d at 1493.

In *Saybrook*, the debtor moved the bankruptcy court to approve a credit transaction involving a creditor's agreement to extend post-petition credit to the debtor in exchange for the debtor's agreement to treat the creditor's pre-petition unsecured claim as entitled to priority on a secured basis.

The bankruptcy court approved the transaction, and two unsecured creditors appealed – first to the district court (which dismissed the appeal under section 364(e)), and then to the Eleventh Circuit.

After discussing the Ninth Circuit's decision in *Adams Apple* and the Sixth Circuit's decision in *Ellingsen*, the Eleventh Circuit rejected the holdings and reasoning of these cases. *Saybrook*, 963 F.2d at 1493. Acknowledging that credit transactions involving the priority treatment of a creditor's pre-petition claim in exchange for post-petition credit is a common practice, the court nevertheless stated that it is a "controversial form of Chapter 11 financing." *Id.* Canvassing various decisions discussing the practice, the court determined that "[c]ross-collateralization is not authorized by section 364." *Id.* at 1495. Concluding on the merits that the bankruptcy court's order was thus erroneous, the Eleventh Circuit held that "[s]ection 364(e), therefore, is not applicable." *Id.* at 1496.

Mirroring the Eleventh Circuit's approach, the court below also concluded on the merits that section 364 does not permit a bankruptcy court to approve a credit transaction that includes the priority treatment of a creditor's pre-petition claim in exchange for the creditor's post-petition extension of credit. Like the Eleventh Circuit, the Seventh Circuit concluded that, because the transaction is not proper under section 364, section 364(e) affords no protection. *In re Kmart*, 359 F.3d at 869.

The approach taken by the Eleventh and Seventh Circuits in applying section 364(e) is diametrically opposed to that taken by the Ninth and Sixth Circuits. According to the Ninth and Sixth Circuits, the appellate court's task in reviewing a bankruptcy court's order approving the terms of a credit transaction is a narrow one. In the absence of a stay of the order pending appeal, the appellate court will preserve the credit transaction for the benefit of the creditor, even if the bankruptcy court's approval of the transaction was erroneous, so long as the creditor extended credit in good faith. In other words, in the absence of a stay, the appellate court's ability to deny the creditor the benefit of its bargain is circumscribed by the bounds of the good-faith standard. The Tenth Circuit also

adheres to this approach in applying section 364(e). *See In re Western Pacific Airlines*, 181 F.3d at 1195 n.2, 1196; *see also In re Revco D.S.*, 901 F.2d at 1363-64 (subsequent panel of Sixth Circuit following *Ellingsen*).

In contrast, according to the Eleventh and Seventh Circuits, the appellate court's task in reviewing a bankruptcy court's order approving the terms of a credit transaction is far broader. Under this approach, the appellate court may deny the creditor the benefit of its bargain, regardless of whether the appellant has sought or obtained a stay, if the appellate court concludes that the bankruptcy court should not have entered the order approving the transaction in the first place. In other words, notwithstanding section 364(e) and the appellant's failure to seek or obtain a stay, the appellate court's ability to deny the creditor the benefit of its bargain is coextensive with its ability to determine whether the bankruptcy court's order was erroneous for some reason *other* than lack of good faith. The Second Circuit also has followed this general approach. *See In re Texlon Corp.*, 596 F.2d at 1198; *see also In re Ellingsen*, 834 F.2d at 607 (Merritt, J., dissenting) (urging an approach similar to that taken by the Eleventh and Seventh Circuits); *In re Revco D.S.*, 901 F.2d at 1367 (Hull, J., dissenting) (same); 3 *Collier*, ¶ 364.04[2][c] at 364-14 (discussing *Saybrook* and noting conflict among the courts of appeals).

Adding further to the disarray in the decisional law, the Third Circuit takes still another approach under section 364(e). *See Swedeland*, 16 F.3d at 562 ("As we already have set forth, in our view section 364(e) does not preclude a court from reversing an authorization absent a stay. What it limits is the effect of a reversal."). Under the *Swedeland* analysis, the appellate court's task in reviewing a bankruptcy court's order approving the terms of a credit transaction is likewise not circumscribed solely by the creditor's good faith and the appellant's success in obtaining a stay. *See id.* (reviewing *Adams Apple*, *Revco*, and *Ellingsen*, and stating that "the courts in the above cases have not read section 364(e) as we did above"). Rather, even if the creditor acted in good faith and the appellant failed to obtain a stay, the appellate court may still modify the

bankruptcy court's order if the appellate court may do so without fundamentally impairing the validity of a fully consummated transaction. Applying this standard, the Third Circuit concluded in *Swedeland* that, because one of the transactions at issue had not yet been fully consummated, the court could still modify the bankruptcy court's order. With regard to a second transaction that had been fully consummated, however, the court concluded that it could not make any modification. *Id.* at 562-63. *See* 3 *Collier*, ¶ 364.06 at 364-22.1 (discussing split of authority between Third Circuit's approach in *Swedeland* and Sixth and Ninth Circuits' approach in *Revco* and *Adams Apple*).

In sum, the circuits are clearly divided on the question presented – whether and to what extent section 364(e) of the Bankruptcy Code protects an order approving a credit transaction from subsequent appellate modification, and the decision of the court below plainly conflicts with decisions of the Third, Sixth, Ninth, and Tenth Circuits.

B. Review Is Further Warranted Because the Decision of the Court Below Conflicts with the Decisions of Other Courts of Appeals on the Proper Application of Section 363(m) of the Bankruptcy Code – a Provision Nearly Identical to Section 364(e).

The decision of the court below also conflicts irreconcilably with the decisions of *ten* other courts of appeals on the proper application of section 363(m) – a provision nearly identical to section 364(e). *See Kontrick v. Ryan*, __ U.S. __, 124 S. Ct. 906, 913 n.6 (2004) (explaining grant of certiorari to resolve conflict of authority on proper construction of Fed. R. Bankr. P. 4004, and citing decision interpreting nearly identical Rule 4007 as illustrating conflict).

In pertinent part, sections 363(b) and (c) of the Bankruptcy Code authorize a bankruptcy court to approve the sale of a debtor's assets. *See* 11 U.S.C. §§ 363(b), (c). In turn, section 363(m) – like section 364(e) – protects the transaction from subsequent appellate modification:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this

> section of a sale . . . of property does not affect the validity of a sale . . . under such authorization to an entity that purchased . . . such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale . . . were stayed pending appeal.

11 U.S.C. § 363(m). Significantly, Congress patterned 364(e) on section 363(m). *See* H.R. Rep. No. 595, 95th Cong., 2nd Sess. 347, *reprinted in* 1978 U.S.C.C.A.N. 5987, 6303 ("Subsection (e) [of section 364] provides the same protection for credit extenders pending an appeal of an authorization to incur debt as is provided under section 363(1) for purchasers: the credit is not affected on appeal by reversal of the authorization unless the authorization and the incurring of the debt were stayed pending appeal."); *see also* 3 *Collier*, ¶ 364.06[1] at 364-22.1 (Section 364(e) "is consistent with section 363(m), which provides similar protection to a buyer . . . of property of the estate in a section 363 transaction.").

In applying section 363(m), numerous courts of appeals have adopted the same approach taken by the Ninth and Sixth Circuits in applying section 364(e) and have refused to overturn a sale order – even an arguably erroneous one – if the purchaser acquired the property in good faith and the objecting party failed to obtain a stay. *See Ginther v. The Ginther Trusts (In re the Ginther Trusts)*, 238 F.3d 686, 688-89 (5th Cir. 2001) (applying section 363(m) and refusing to consider challenge to bankruptcy court's order where appellant failed to obtain a stay); *Development Co. of America v. Adamson Co. (In re Adamson Co.)*, 159 F.3d 896, 897-98 (4th Cir. 1998) (applying section 363(m) and refusing to overturn sale order in the absence of a stay and lack of good faith); *Paulman v. Gateway Venture Partners III, LP (In re Filtercorp, Inc.)*, 163 F.3d 570, 576-77 (9th Cir. 1998) (applying section 363(m) and stating "[w]hen a sale of assets is made to a good faith purchaser, it may not be modified or set aside unless the sale was stayed pending appeal"); *Licensing By Paolo v. Sinatra (In re Gucci)*, 126 F.3d 380, 389 (2d Cir. 1997) (stating in section 363(m) case that "[w]e cannot take any action that affects the judicially-authorized sale if the purchaser acted in good faith and no

stay was granted"); *Anheuser-Busch, Inc. v. Miller (In re Stadium Mgmt. Corp.)*, 895 F.2d 845, 847 (1st Cir. 1990) (applying section 363(m) and stating "[a]bsent a stay, the court must dismiss a pending appeal [of a sale order] as moot because the court has no remedy that it can fashion even if it would have determined the issues differently"); *Hicks v. Pearlstein (In re Magwood)*, 785 F.2d 1077, 1080 (D.C. Cir. 1986) (Edwards, Ginsburg, and Scalia, JJ.) (concluding that, under section 363(m), the court had no authority to overturn a sale order and stating that "a sale made to a good faith purchaser pursuant to section 363(b) or (c) of the Code . . . cannot be overturned on appeal unless the sale was stayed pending appeal"); *Sulmeyer v. Karbach Enters. (In re Exennium, Inc.)*, 715 F.2d 1401, 1404 (9th Cir. 1983) ("If appeal is sought without a stay, the courts cannot grant relief because they cannot overturn the sale."); *see also Tompkins v. Frey (In re Bel Air Assocs., Ltd.)*, 706 F.2d 301, 304-05 (10th Cir. 1983) ("[A] party appealing from an order which authorizes the sale of property of a debtor should obtain a stay of the order. Otherwise the property may be sold to a 'good faith purchaser,' removing the property from the jurisdiction of the courts and rendering moot the appeal from the order authorizing the sale.").

In addition, the Third and Eighth Circuits have applied an approach under section 363(m) that mirrors the Third Circuit's *Swedeland* standard under section 364(e). *See Official Comm. of Unsecured Creditors v. Trism, Inc. (In re Trism, Inc.)*, 328 F.3d 1003, 1006-07 (8th Cir. 2003) ("The language of section 363(m) moots any challenge to an order approving the sale of assets that satisfies two requirements: First, no party obtained a stay of the sale pending appeal. . . . Second, 'reversing or modifying the authorization to sell would affect the validity of the sale. . . .'") (quoting *Cincola v. Scharffenberger*, 248 F.3d 110, 122 (3d Cir. 2001)); *L.R.S.C. Co. v. Rickel Home Ctrs., Inc. (In re Rickel Home Ctrs., Inc.)*, 209 F.3d 291, 297-98 (3d Cir. 2000) (applying two-part standard under section 363(m)).

Given the close similarly between sections 364(e) and 363(m), together with the close similarity in the divergent approaches taken by the courts of appeals in applying these parallel statutory provisions, reference to circuit authority under section 363(m) serves to demonstrate further the extent

to which the decision of the court below conflicts with decisions of other courts of appeals. Certiorari is especially warranted to resolve the conflict, given that *all* of the courts of appeals have addressed the proper application of either section 364(e) or section 363(m) (or both), and given the extent of the three-way split of authority within the combined body of precedents.

C. Review Is Further Warranted Because the Conflict Will Not Resolve Itself Absent the Court's Intervention.

The conflicting approaches to the proper application of section 364(e) are irreconcilable. Absent review by this Court, the split of authority among the courts of appeals will not resolve itself. For example, the Ninth and Sixth Circuits have adhered to their positions on the question presented for over fifteen years. Similarly, the Eleventh Circuit has maintained its contrary approach for nearly as long, and, far from assisting in any resolution, the decision of the court below merely exacerbates the existing disagreement.

Although conflicts among the courts of appeals are sometimes resolved through *en banc* procedure, both the court below and the Sixth Circuit have declined to exercise *en banc* review on the question presented, thus ensuring that the disagreement will continue. In addition, the fact that the conflict over the question presented mirrors a larger, more general, conflict among the courts of appeals over the proper application of sections 364(e) and 363(m) further demonstrates the intractable nature of the conflict and the need for this Court's intervention. Finally, given the number of decisions that have addressed the relevant issues under section 364(e), together with the number of decisions that have addressed the same issues under section 363(m), no point would be served by awaiting additional opinions from the courts of appeals before this Court intercedes. Because the relevant issues have been fully aired, and because the conflict among the courts of appeals is deeply entrenched, certiorari should be granted.

D. This Case Presents an Ideal Vehicle for the Resolution of the Question Presented.

This case presents an ideal vehicle for resolution of the conflict among the courts of appeals over the question presented because the issue is presented simply and clearly and its resolution is outcome-determinative. In addition, this case presents an ideal vehicle to resolve the conflict among the circuits because it involves the very type of bankruptcy credit transaction responsible for the division among the courts of appeals over the proper application of section 364(e). Further, because the form of credit transaction in this case is exceedingly common, the issue of an appellate court's ability to review the transaction under section 364(e) will recur again and again.

In entering the Vendor Order, the bankruptcy court approved a credit transaction that included as one of its terms the treatment of Irving's pre-petition invoices as a priority obligation payable in Kmart's bankruptcy case as an expense of administration. After the bankruptcy court entered the Vendor Order, Irving agreed to the terms of the Order and shipped goods to Kmart on credit. In turn, Kmart paid Irving's pre-petition invoices as a priority expense.

In affirming the district court's reversal of the Vendor Order, the Seventh Circuit concluded that the protections of section 364(e) do not apply because the bankruptcy court's approval of the Vendor Order was erroneous. Specifically, the court concluded that the bankruptcy court erred in approving the Order because one of the key terms of the credit transaction – the treatment of the suppliers' pre-petition invoices as a priority obligation – was not appropriate. This determination falls squarely within the scope of the conflict of authority initiated by *Adams Apple* and *Saybrook*.

Irving contends that the Seventh Circuit misapplied section 364(e) because, regardless of whether the bankruptcy court's Vendor Order was erroneous, the Seventh Circuit could not overturn the Order for the reasons that it gave. Because Irving extended credit under the terms of the Vendor Order, an appellate court could only overturn the Order, consistent

with section 364(e), if Irving extended credit in bad faith or if Capital obtained a stay pending appeal. This is an argument that would have prevailed in the Third, Sixth, Ninth, and Tenth Circuits under existing decisional authority applying section 364(e), and likewise would have prevailed in the First, Third, Fourth, Fifth, Eighth, Ninth, Tenth, and D.C. Circuits under existing decisional authority applying section 363(m). There is no dispute that Capital failed to seek, let alone obtain, a stay pending appeal. In addition, there is no indication that Irving extended credit in bad faith. At no point in the proceedings below did Capital argue (much less demonstrate) that Irving acted in bad faith. On the contrary, Capital conceded at oral argument that the critical suppliers, including Irving, had done nothing untoward or underhanded in the case. (Pet. App. 86a) (in response to question regarding the arms'-length nature of the transactions with the vendors, counsel for Capital stated: "I don't mean to imply that there was any underhanded methods here at all.").

But even if Capital were to question Irving's good faith at this point, that would have no bearing on the resolution of the question presented because the court below did not rely on the issue of good faith in rendering its decision. Rather, the court simply concluded as a matter of law that the protections of section 364(e) do not apply because section 364 does not authorize an order approving a credit transaction that includes as one of its terms the treatment of a creditor's pre-petition claim as a priority obligation payable as an expense of administration. Whether the Seventh Circuit was correct in reaching this conclusion is an independent question of law over which there exists a conflict of authority among the courts of appeals. Accordingly, the question presented arises simply and clearly and is thus well-positioned for review in the context of a bankruptcy court's order approving a common credit transaction in chapter 11 cases.

The resolution of the question presented is also outcome-determinative. If Irving does not prevail on the question, it will lose the protection of the Vendor Order regardless of whether it extended credit in good faith. In contrast, if Irving prevails on the question under the approach taken by the Sixth,

Ninth, and Tenth Circuits, or the alternative approach taken by the Third Circuit, then it will retain the protection of the Vendor Order. If any issue of good faith remains, it may be addressed on remand.

II. The Conflict Among the Courts of Appeals is Untenable Given the Importance of the Question Presented.

Bankruptcy courts approve credit transactions in virtually every chapter 11 case, and Congress enacted section 364(e) to facilitate the immediate consummation of these transactions by enhancing the certainty that they would not be modified on appeal. The decision of the court below seriously erodes the protection and utility of section 364(e), and thus impacts tens of thousands (if not hundreds of thousands) of credit transactions in the bankruptcy context. Inevitably, creditors faced with the prospect of having their credit transactions undone on appeal *after* they have extended credit will be far less likely to do business with chapter 11 debtors. As a result, chapter 11 debtors will find it far more difficult to reorganize – a result demonstrably at odds with Congress' intent in enacting section 364(e) and chapter 11 as a whole. *See Bank of America v. 203 North LaSalle St. P'ship*, 526 U.S. 434, 453 (1999) (recognizing goal of chapter 11 of "preserving going concerns"); *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 527 (1983) ("the policy of Chapter 11 is to permit successful rehabilitation of debtors"); *In re Adams Apple*, 829 F.2d at 1489 (discussing section 364(e)'s purpose of facilitating lending in chapter 11); H.R. Rep. No. 595, 95th Cong., 2nd Sess. 347, *reprinted in* 1978 U.S.C.C.A.N. 5987, 6303 (discussing role of section 364(e) in facilitating lending).

This case also well illustrates the enormous burden, uncertainty, and inequity that the decision of the court below has placed on the administration of chapter 11 proceedings. In the Kmart case alone, *thousands* of trade creditors extended *billions* of dollars in post-petition trade credit to Kmart on the strength of the Vendor Order. In turn, after the Seventh Circuit affirmed the district court's reversal of the Vendor Order, Kmart has pursued *thousands* of lawsuits seeking to recover hundreds of millions of dollars representing Kmart's payment

of the pre-petition invoices of these suppliers. This is precisely the inequity, instability, and waste of resources that section 364(e) is intended to avoid.

Chapter 11 cannot operate as Congress intended with these burdens in place. The decision below has swamped the bankruptcy court's docket with thousands of pending lawsuits and seriously burdened the administration of Kmart's bankruptcy case. Not surprisingly, large corporate debtors in need of reorganization and with a choice of venue have avoided commencing their cases within the Seventh Circuit. Because the decision below affects innumerable credit transactions in thousands of chapter 11 cases, and puts billions of dollars in credit financing at risk, certiorari is warranted.

III. Certiorari Is Also Warranted Because the Decision of the Court Below Is Wrong on the Merits.

As this Court has instructed repeatedly, the starting point in construing the Bankruptcy Code is the text of the statute itself. *See Lamie v. United States Trustee*, __ U.S. __, 124 S. Ct. 1023, 1030 (2004) ("The starting point in discerning congressional intent is the existing statutory text"). In this case, section 364(e) plainly provides that Irving is entitled to the benefit of the Vendor Order unless Irving extended credit in bad faith or Capital obtained a stay pending appeal. Because the statute is plain and unambiguous, the court below should have looked no further than the governing text. *See Hartford Underwriters*, 530 U.S. at 6 ("[W]hen the statute's language is plain, the sole function of the courts . . . is to enforce it according to its terms.") (internal quotation marks and citations omitted); *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 254 (1992) (same).

In this case, the court below acknowledged that section 364(e) "forbid[s] revision of transactions completed under judicial auspices." (Pet. App. 4a). Nevertheless, the court concluded that the Bankruptcy Code does not authorize a credit transaction that includes as part of its terms the payment of the creditor's pre-petition claim and, thus, that Kmart could recover the payments that it made to its suppliers on account of their pre-petition invoices. (Pet. App. 3a-4a). The court's

acknowledgement that section 364(e) forbids appellate revision of court-approved credit transactions, however, should have ended the matter in view of Capital's failure to obtain a stay and the absence of any indication that Irving extended credit in bad faith.

A critical flaw in the Seventh Circuit's decision lies in its methodology. Instead of beginning with the text of section 364, the court commenced its analysis by considering whether it makes sense as a theoretical matter to allow a bankruptcy court to approve a credit transaction in which the debtor agrees to pay the creditor's pre-petition invoice as part of the terms of the creditor's post-petition extension of credit. (Pet. App. 1a-2a). The court reasoned that, if it did not make sense to allow this type of credit transaction, then Kmart is entitled to recover whatever amounts it had paid to the suppliers on account of their pre-petition invoices, even though the suppliers had already extended credit on the strength of the Vendor Order. (Pet. App. 3a-4a) ("If the orders in question are invalid, then the critical vendors have received preferences that Kmart is entitled to recoup for the benefit of all creditors."). Respectfully, the Seventh Circuit's method of addressing the soundness of the credit transactions at issue and announcing Kmart's remedy before considering its authority under section 364(e) is wrong. The proper method is that embraced by the Sixth, Ninth, and Tenth Circuits, which properly recognizes that the ability of an appellate court to deny a creditor the benefit of a court-approved credit transaction is circumscribed by the standard of good faith and whether the party objecting to the transaction obtained a stay pending appeal.

The Seventh Circuit also is wrong in its conclusion that permitting credit transactions of the kind at issue here is inappropriate under the Bankruptcy Code. In this case, the Vendor Order authorized Kmart to enter into a post-petition credit transaction with Irving that allowed Kmart to purchase goods post-petition on credit on certain enumerated terms. Under the express provisions of the Vendor Order, the payment of Irving's outstanding pre-petition claim was simply part of the price that Kmart agreed to pay for Irving's extension of

credit, including Irving's waiver of its lien and reclamation rights. This was clearly appropriate.

It is beyond dispute that section 364 authorizes a debtor to pay *some* price for post-petition credit. It is also clear that section 364 does not circumscribe the range of permissible credit terms that a debtor may propose or that the court may approve, apart from limiting the debtor's ability to offer superpriority status or collateral to ensure payment. For example, section 364 says nothing about price terms (including any applicable rate of interest or schedule of fees); the duration of the credit; or the creditor's collection rights upon the debtor's default. Instead, section 364 provides a plenary authorization to enable debtors to obtain credit on whatever terms the marketplace may require.

First, section 364(a) authorizes the debtor to obtain post-petition credit "in the ordinary course of business" – meaning credit that the debtor ordinarily would obtain to conduct its business operations, such as ordinary trade credit. The debtor pays for this category of credit as an unsecured expense of administration. Significantly, section 364(a) does not otherwise circumscribe the terms of credit, and no notice of the transaction or hearing is required for it to be valid. 11 U.S.C. § 364(a).

Second, section 364(b) authorizes the debtor to obtain post-petition credit other than under section 364(a). The debtor also pays for this category of credit as an expense of administration. Like section 364(a), section 364(b) does not circumscribe the parties' credit terms, but does require a hearing on notice for approval of the transaction. 11 U.S.C. § 364(b).

Third, section 364(c) authorizes the debtor to obtain and pay for post-petition credit on either a superpriority or secured basis. Unlike sections 364(a) and (b), this authorization has an exhaustion requirement: The debtor may only proceed under section 364(c) if it is unable to obtain credit under sections 364(a) or (b). Hence, section 364(c) expresses the policy that a debtor should use administrative expense priority treatment to pay for its post-petition credit wherever possible. The provision does not otherwise circumscribe the parties' credit terms, but notice and a hearing are required.

Finally, section 364(d) authorizes the debtor to obtain and pay for post-petition credit on a secured basis with the creditor's secured position priming other preexisting liens. This section has a stringent exhaustion requirement: The debtor must be unable to obtain credit under sections 364(a), (b), or (c). Further, the debtor must provide adequate protection to any lienholder prejudiced by the new lien granted to the post-petition lender. *See In re Qualitech Steel Corp.*, 276 F.3d 245, 247 (7th Cir. 2001) (observing that preexisting secured lenders entitled to replacement security to maintain their financial position where debtor placed new liens ahead of preexisting security interests). The section otherwise does not restrict the terms of credit, although notice and a hearing are required. 11 U.S.C. § 364(d).

In economic substance, the Vendor Order approves credit terms that are no different than if Kmart had agreed to buy goods from Irving post-petition at a price 10% higher than Irving normally would charge until Irving recouped its pre-petition loss for its unpaid pre-petition invoices. (Indeed, unpaid vendors often raise their prices on post-petition shipments to recoup pre-petition losses from bankrupt debtors if they have the leverage to do so, and sophisticated debtors, such as Kmart, are aware of this). Significantly, this type of transaction (the post-petition sale of goods at a marginally increased price) is authorized without a hearing or court order under section 364(a). In addition, under section 364(a), Kmart's obligation to pay for goods at a price that included a 10% increase would be accorded administrative expense status. Just as this type of transaction is authorized by section 364, so, too, is Irving's extension of credit under the terms of the Vendor Order.[8]

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8. The Bankruptcy Code does not define precisely the point at which the terms of a proposed credit transaction fall outside the "ordinary course of business" within the meaning of section 364(a). The distinction is irrelevant in this case, however, because credit terms that do not qualify under section 364(a) may nonetheless be approved under section 364(b). The only difference between the approval requirements of section 364(a) and (b) is that section (b) requires notice and a hearing. Because the bankruptcy court held a hearing on notice in this case, it is immaterial whether the Vendor Order is authorized under section (a) or section (b).

In this instance, of course, rather than sell goods to Kmart at a higher price post-petition, the Vendor Order authorized Kmart to obtain credit from Irving at a price that included the payment of Irving's pre-petition claim all at once. Moreover, Kmart's agreement to treat Irving's pre-petition claim as an administrative expense in exchange for Irving's agreement to extend post-petition credit involves an exchange of valuable consideration and was clearly not gratuitous.

As part of the bargain, Irving agreed to give up its lien and reclamation rights with respect to its pre-petition shipments (which rights, if proven, would have entitled Irving to have some, but not all, of its pre-petition claim treated as an administrative expense). Further, in binding itself to ship goods post-petition for a two-year period on ordinary credit terms (without interest, provision for collateral, additional fees, or other costly protections), Irving took on the risk that Kmart would not be able to pay all of its administrative claims in full. This is a considerable risk in chapter 11 proceedings, in which a substantial number of debtors are unable to pay in full all administrative claims.[9]

It is also clear that the bankruptcy court's entry of the Vendor Order was beneficial to Kmart's estate. Among other things, the estate obtained the benefit of Irving's extension of credit, the avoidance of litigation over Irving's lien and reclamation rights, the normalization of Kmart's relationship with a key supplier, and the avoidance of a potentially disastrous disruption in Kmart's business.

In its ruling, the Seventh Circuit stated that, before approving the payment of a vendor's pre-petition invoice as part of a credit transaction, the bankruptcy court must consider alternative means of enticing the vendor's business, such as payment for the shipments on a "COD" basis or by use of a letter of credit. (Pet. App. 12a). Section 364, however, explicitly eschews such a standard. The statute requires the exhaustion of alternative credit terms *only* in the context of selecting whether the creditor will receive payment of the price of the

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9. *See* note 5 *supra*.

credit on a superpriority or secured basis. No other exhaustion requirement exists, and none is warranted.

The Seventh Circuit also stated that vendors would have done business with Kmart even if their pre-petition claims had not been afforded administrative priority treatment, and the court used one of Kmart's food suppliers, Fleming, as an example. (Pet. App. 11a-12a). The court's analysis, however, is mistaken, both as a statutory presumption and as a factual predicate.

First, if businesses would never routinely refuse to sell goods and services to bankrupt debtors so long as they have assurance of future payment for future sales, then Congress would never have seen fit to enact section 366 of the Bankruptcy Code. 11 U.S.C. § 366 (providing that a utility may not discontinue service to a debtor because the debtor owes a pre-petition debt to the utility; and that a utility must provide post-petition service if given adequate assurance of post-petition payment for post-petition service). Contrary to the Seventh Circuit's analysis, section 366 reflects the reality that some suppliers may well refuse to do business with bankrupt debtors, even if provided assurance of future payment for future sales, and the list is not limited to utilities. *See In re Crawford*, 324 F.3d 539, 543 (7th Cir. 2003) (providing illustration of non-utility supplier who might refuse to sell goods to the debtor unless the debtor paid the supplier's pre-petition invoice). Conversely, if Congress had intended to prohibit post-petition suppliers of goods and services from discontinuing business with the debtor unless their pre-petition invoices were paid, Congress could have expanded section 366 to cover more than just utilities. Section 364, however, contains no such restriction.

Second, the Fleming example also disproves the Seventh Circuit's point. As the court observed, when Kmart eventually found an alternative supplier and ceased doing business with Fleming, Fleming failed immediately and filed its own bankruptcy case. (Pet. App. 12a). Had Kmart not paid Fleming's pre-petition claim at the outset of Kmart's bankruptcy case, Fleming would have failed before Kmart had the chance to find an alternative supplier. Because this would

have proved disastrous for Kmart at the outset of its case, it was appropriate for Kmart to pay Fleming's claim for the benefit of Kmart's estate.

With respect to other critical suppliers, the court below also overlooked the risks associated with Kmart's "playing chicken" with these vendors; the rights that these vendors gave up in agreeing to extend credit (e.g., their lien and reclamation rights); and the other benefits of the Vendor Order (discussed above). In this case, Kmart made a business judgment designed to preserve its estate for the benefit of all concerned. Kmart also explained its business judgment to the bankruptcy court and backed its explanation with an affidavit and live testimony. (Pet App. 48a-49a; 51a-58a; 67a-70a; 81a-84a). The bankruptcy court understood that the Vendor Order involved a financing transaction in which the suppliers would provide trade credit to Kmart – the relevant credit terms were clearly and comprehensively spelled out in the both Kmart's motion and the Order itself. (Pet. App. 30a-33a; 51a-56a). Kmart's presentation was adequate, and all agreed with Kmart's judgment to pursue the transactions, save one - Capital. Section 364 authorizes Kmart's decision, and the decision of the bankruptcy court to approve the Vendor Order should not have been overturned.

CONCLUSION

For the foregoing reasons, Irving respectfully requests that the Court issue a writ of certiorari to review the decision of the Seventh Circuit in this case.

Respectfully submitted,

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